

Subprime bets put Lehman on hot seat

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This week's earnings news may be dismal; heavy reliance on mortgages to blame

In a conference call with investors three months ago, Lehman Brothers' chief financial officer flatly predicted that "the worst of the credit correction is behind us."

This week, the big investment bank is expected to bury that earlier optimism. Analysts believe that Lehman will post its first drop in fourth-quarter earnings since 2001, in a stunning signal that the credit crisis is anything but over.

In fact, November--the last month of the fiscal year for many financial firms--was the worst month for Wall Street since the bond markets began to freeze up in the summer.

Lehman, which generated nearly half its revenues last year from selling and trading bonds, is far more vulnerable than most of its peers.

"There simply aren't buyers for the things Lehman sells," says Punk Ziegel analyst Dick Bove. "Mortgages, credit products, you name it--there's no market for the things it specializes in."

While Lehman will have lots of company in reporting dismal earnings, in some ways, it's the Wall Street firm with the most to lose.

Time to pay the piper

Under Chief Executive Richard Fuld, the firm has earned a reputation as one of the best-run banks. Along with Goldman Sachs, it has managed to avoid the carnage in the markets so far. But Lehman was the nation's largest dealer in subprime mortgages over the past two years, and bears are betting that the time has finally come for the firm to pay the piper.

The biggest problem is that the hugely profitable business of packaging residential mortgages into complex securities has all but shut down. That has left Lehman with an inventory of \$6 billion in subprime mortgages and another \$16 billion in related securities that no one wants to buy, and whose value has eroded.

To date, Lehman has contained the damage, marking down the value of its mortgage book by about \$500 million. Last month, the firm's co-chief administrative officer insisted that a "substantial" fourth-quarter markdown won't be required.

But considering that an index tracking subprime mortgage securities fell by 46% over the past three months, skeptics believe that Lehman will have to bite the bullet. They forecast a write-down ranging from \$1.5 billion to as much as \$3.9 billion.

“Merrill Lynch has said, ‘We've got problems with subprime,’ yet Lehman officials say they've nailed it,” notes David Einhorn, chairman of hedge fund Greenlight Capital, who is shorting Lehman's shares. “I don't believe them.”

A Lehman spokeswoman declined to comment.

Damaging blows

While Lehman's subprime-related losses are unlikely to be as large as those taken by Merrill or Morgan Stanley, they would do more damage to Lehman, because its capital base is significantly smaller.

Meanwhile, another key Lehman business line--the packaging of mortgages backing office buildings and shopping malls--is showing cracks. Wall Street firms sold \$23 billion worth of commercial mortgage-backed securities in the past two months, compared with an average quarterly pace of \$65 billion earlier in the year.

Worse, questions are now surfacing regarding the safety and quality of commercial mortgages. Fitch Ratings warned late last month that for the first time since the credit crisis began, it might downgrade a commercial mortgage-backed security sold by Lehman. The bond is backed by a loan for a business condominium in the glutted Las Vegas market that is “no longer performing,” according to a Fitch analyst.

Analysts expect Lehman to earn \$1.49 a share in the fourth quarter--13% less than it did in the final quarter of last year--according to Reuters Fundamentals. Skeptics say that those projections are out of whack with the worsening credit markets.

“Firms that did less subprime mortgage business than Lehman have suffered quite a bit, so it makes sense that Lehman would have to take a really big write-down,” says Amit Chokshi, founder of hedge fund Kinnaras Capital Management.

Broad retreat

Compounding Lehman's problems, and those of its Wall Street peers, are huge declines in other businesses not tied so closely to mortgages. The dollar value of U.S. corporate mergers announced in the three months ended Nov. 30 skidded 49% versus the year-earlier period, according to Bloomberg. An even bigger headache for Lehman centers on the dormant market for leveraged buyouts. Lehman is trying to find buyers for the \$27 billion in loans it has committed to fund LBOs.

“The way LBOs get done now is that banks take the loans they wanted to sell back onto their own books, creating losses,” says Chris Donnelly, an analyst at Standard & Poor's. When Lehman finally reveals its results next week, don't expect to hear from the CFO who confidently forecast better times. He was reassigned effective Dec. 1. He now heads risk management.